

This letter makes rulings regarding the application of the manufacturing machinery and equipment and Manufacturer's Purchase Credit to a steam and electricity producing operation. See 86 Ill. Adm. Code 130.330 and 130.331. (This is a PLR.)

November 20, 2003

Dear Xxxxx:

This Private Letter Ruling, issued pursuant to 2 Ill. Adm. Code 1200 (see www.revenue.state.il.us), is in response to your letter of March 10, 2003. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to AAA for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither AAA nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

In your letter, you have stated and made inquiry as follows:

The purpose of this letter is to request a Private Letter Ruling pursuant to 2 Ill. Admin. Code 1200.120 regarding the Illinois Retailers' Occupation Tax ('ROT') and use tax consequences of a proposed restructuring of AAAs coal-fired electric generation facilities.

Facts

Current Corporate Structure

BBB is the holding company for a number of subsidiaries, including AAA. AAA, which is an intermediate holding company, owns all of the stock of several corporations, including CCC. CCC owns all the stock of DDD.

DDD is engaged in the business of generating and selling electricity. DDD sells all of the electricity produced by its generation facilities to an affiliate, XYZ, which resells the electricity to wholesale and retail electric customers. DDD owns coal-fired electric generation facilities in Illinois as well as natural gas-fired electric generation facilities in Illinois and STATE. The issues presented in this request are related solely to a restructuring involving DDD's coal-fired electric generation facilities in Illinois.

Current Operation of DDD

Each of DDD's coal-fired electric generation facilities produces steam and electricity by using coal as the fuel. The operations of such a facility can best be described as comprised of steam production and electricity production.

A. Steam Production

Steam production commences with the delivery of coal to the plant site. A system of bulldozers, conveyors, coal mills and blowers transports the coal into a boiler, where the coal is ignited. The resulting heat from the burning coal transforms water, which is known as 'boiler feedwater,' located inside a system of boiler tubing, to steam. The steam, which at this point in the process is under extremely high pressure, is used for electricity production, which is described below. After electricity production, the steam is directed to a condenser, where it is passed over and around tubes containing cold water, which causes the steam to condense into condensate after it loses its heat.

The cooling water used in the condenser is pumped from a body of water through the tubes and back to the body of water. From the condenser, the condensate along with a residual amount of low-pressure steam is pumped back to the boiler and used as boiler feedwater for producing the steam again. The cooling water system and the steam condensate system are separate, closed systems.

B. Electricity Production

Electricity production begins by directing the high-pressure steam produced by the steam production process through turbines, which are mechanically coupled to generators. The steam flow into the turbines is controlled by stop valves. The flow of the steam through a turbine causes the turbine to rotate, thereby spinning the generator, which generates electricity. The electricity produced by the generators is directed through transformers into a 'grid' for transmission and distribution to customers.

Proposed Structure

This request for private letter ruling is focused on the Illinois ROT and use tax consequences of segregating DDD into two separate legal entities. One entity ABC will operate a steam manufacturing business, and the other entity JKL will generate and sell electricity.

JKL would own the turbines, generators, condensers, transformers and switchyard and other assets associated with the electricity production process described above, including the stop valves and connecting piping to the turbine, and would be engaged in the business of generating and selling electricity. ABC would own the assets associated with the steam production process, including the piping from the ABC boilers to the turbine main steam stop valves and the piping from JKL's condensers to ABC's boilers. Attached is a flowchart of the current and proposed structures.

ABC would manufacture and sell steam at retail to JKL at each coal-fired electric generation facility. ABC would purchase coal from third-party vendors, and condensate from JKL. The coal and the condensate would be used in ABC's steam manufacturing operation.

JKL would purchase steam from ABC for use in its business of generating and selling electricity. The steam transferred to JKL, and the condensate, which results when the steam loses its heat, will later be resold by JKL to ABC for use in its steam manufacturing operation. JKL would issue a resale exemption certificate to ABC. ABC would issue a resale exemption certificate to JKL.

Initially, ABC would sell steam only to JKL. However, ABC is aggressively pursuing other market opportunities.

Issues

Prior to committing to the formation of JKL, DDD would like to make sure that it has authoritative answers on which it can rely to the following questions concerning the Illinois ROT and use tax:

1. Under the proposed structure, will ABC's steam production operation qualify as a manufacturing operation as defined in Section 130.330?
2. If ABC's steam production operation qualifies as a manufacturing operation, will ABC be eligible for the manufacturing exemption set forth in Section 130.330?
3. If ABC's steam production operation qualifies as a manufacturing operation, will ABC be eligible for the Manufacturer's Purchase Credit set forth in Section 130.331?

Conclusions

Our conclusions, based on the analysis given below, are as follows:

1. ABC's proposed steam production operation is a manufacturing operation as defined in Section 130.330.
2. Under the proposed structure, ABC will be eligible for the manufacturing exemption set forth in Section 130.330.
3. Under the proposed structure, ABC will be eligible for the Manufacturer's Purchase Credit set forth in Section 130.331.

Analysis

According to Department of Revenue regulation, 86 Ill. Admin. Code 130.330(b)(2), the 'manufacturing process is the production of any article of tangible personal property, whether such article is a finished product or an article for use in the process of manufacturing or assembling a different article of tangible personal property, by procedures commonly regarded as manufacturing, processing, fabrication or refining which changes some existing material or materials into a material with a different form, use or name. These changes must result from the process in question and be substantial and significant.'

Pursuant to Department of Revenue regulation, 86 Ill. Admin. Code 130.2156, vendors of steam are responsible to collect and remit ROT on the sale of steam to their

customers. This regulation provides the basis that ABC is producing an article of tangible personal property as required in Section 130.330(b)(2). The production and sale of steam is clearly regarded as a manufacturing operation.

The Department of Revenue has acknowledged in a general information letter that if a producer of steam sells steam at retail and transfers the condensate to the customer, then the steam producer can qualify as a manufacturer. Illinois Department of Revenue Ruling No. 97-0268-GIL, May 15, 1997.

Summary

DDD requests a private letter ruling on which it can rely from the Illinois Department of Revenue confirming its conclusions on the Illinois ROT and use tax issues discussed herein. DDD has appointed MNO to prepare this private letter-ruling request and to discuss any issues raised herein with any personnel designated by the Illinois Department of Revenue. A power of attorney formalizing this appointment is attached.

Please contact PERSON with any questions or comments you may have. DDD would request that no negative ruling be issued on any issues raised in this letter without prior discussion of the issue(s) between the Department and DDD. If the Department is in agreement with the analysis and conclusions presented in this private letter ruling request, we would request that the Department issue the private letter ruling.

Question 1: Under the proposed structure, will ABC's steam production operation qualify as a manufacturing operation as defined in Section 130.330?

Based upon the information provided, it is our opinion that under the proposed structure, ABC's steam production operation would qualify as a manufacturing operation as defined in Section 130.330. This is because ABC is manufacturing steam that is for wholesale or retail sale or lease. More importantly, as we discussed on the phone, the steam will be sold not only to JKL but also to an unrelated third party buyer.

As you know, the Department considers steam to be sold at retail and subject to tax when the steam is sold and the condensate is transferred. Persons who are engaged in the business of selling steam to purchasers for use or consumption and not for resale, incur Retailers' Occupation Tax liability on their receipts from such sales. In the situation described, ABC sells the steam to JKL as a sale for resale. As a result, when ABC sells the steam to JKL, JKL can issue a resale exemption certificate to ABC and no tax liability is incurred.

Likewise, when JKL sells the condensate to ABC, JKL is making a sale for resale. This is because the condensate is an ingredient of the steam. ABC does not use the condensate for another purpose. As a result, when JKL sells the condensate to ABC, ABC can issue a resale exemption certificate to JKL and no tax liability is incurred.

Question 2: If ABC's steam production operation qualifies as a manufacturing operation, will ABC be eligible for the manufacturing exemption set forth in Section 130.330?

It is possible that equipment used by ABC in the steam manufacturing process could qualify for the manufacturing machinery and equipment exemption; however, no specific equipment has been

described. Therefore, we are unable to issue a ruling regarding whether any specific equipment qualifies.

The Department's regulation at 86 Ill. Adm. Code 130.330 provides that the exemption is available for machinery and equipment used primarily in the manufacturing or assembling of tangible personal property for wholesale or retail sale or lease. Equipment that is used to produce steam for sale, qualifies, so long as this is the primary use of the equipment. Please note that only manufacturing machinery and equipment described in Section 130.330 would qualify. Equipment that is involved in preproduction processes rather than manufacturing, for example, would not qualify.

Question 3: If ABC's steam production operation qualifies as a manufacturing operation, will ABC be eligible for the Manufacturer's Purchase Credit set forth in Section 130.331?

Pubic Act 93-0024 repealed the MPC credit. MPC may no longer be earned after June 30, 2003. All MPC that has been accrued must be used prior to October 1, 2003. MPC reported on any original or amended return filed after October 20, 2003 will be disallowed.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

I hope this information is helpful. If you have further questions concerning this Private Letter Ruling, you may contact me at (217) 782-2844. If you have further questions related to the Illinois sales tax laws, please visit our website at www.revenue.state.il.us or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Martha P. Mote
Associate Counsel

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